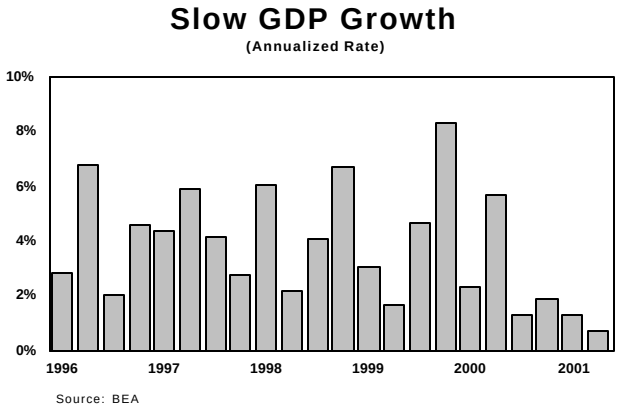
AUGUST 2001

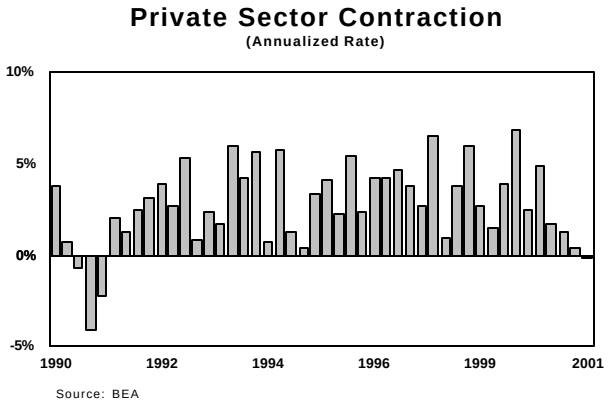
US OVERVIEW

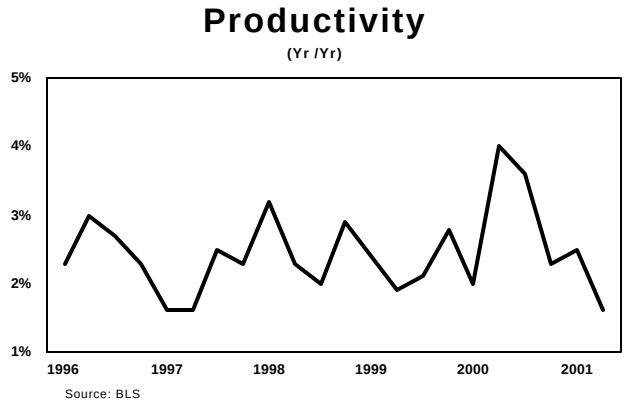
The economy remains weak. A dramatic slowdown in business investment, particularly high-tech investment, is at the heart of the slowdown. In the months ahead, growth will be assisted by tax rebates, declining energy prices, and rising home values. However, working against a recovery will be declining business profits, excess inventories, rising joblessness, and a bear market in stocks. The Federal Reserve has reduced rates from 6.5% at the beginning of the year to 3.75% today and is likely to continue to reduce rates.

Weak Second Quarter

The advance estimate on second quarter GDP showed only 0.7% growth, the slowest pace since 1993. The estimate will be revised at the end of both August and September and, given intervening data, stands a chance of being revised to a negative number. Second quarter data already show the private sector contracting. Excluding federal, state, and local expenditures, the economy would have shrunk in the second quarter for the first time since the 1990-91 recession. The employment report for July showed a continued decline in aggregate hours worked, making a drop in third quarter GDP a distinct possibility.





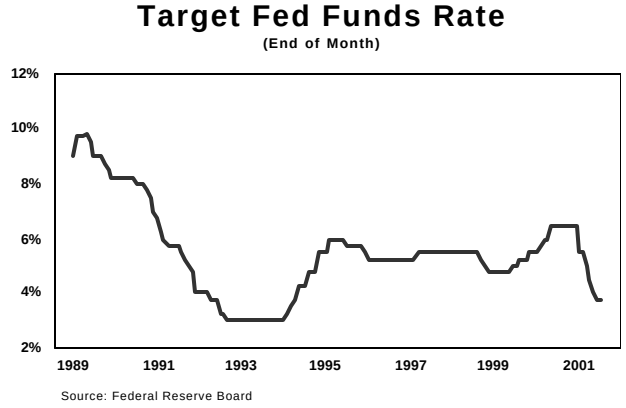


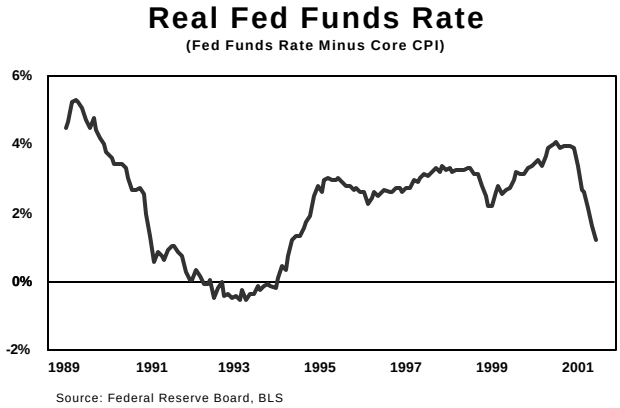
Looking on the bright side, productivity data still suggest underlying economic strength once we get past the cyclical slowdown. Productivity grew at a 2.5% rate in the second quarter and has grown at a 1.6% rate since the slowdown began in mid-2000. Not bad at all considering the extent of the slowdown.

FOCUS: MONETARY POLICY

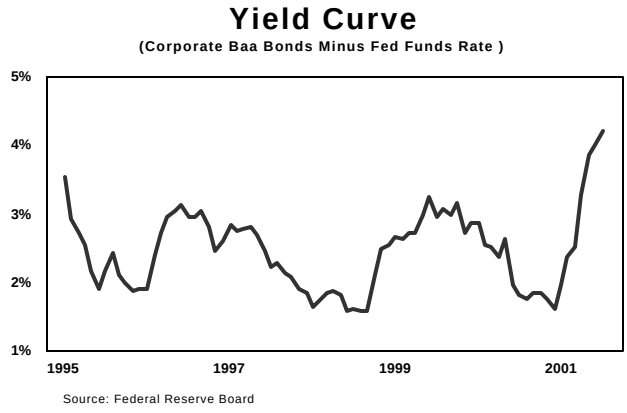
In an attempt to cushion the economy and resuscitate economic growth, the Federal Reserve has lowered interest rates from 6.5% to 3.75% so far this year – the steepest reduction since 1984-85. The financial markets now expect two more 25 basis point rate cuts in the next few months. However, the level of rates and the steepness of the rate cuts do not by themselves tell us whether monetary policy is loose, neutral, or tight.

Many analysts look at the *real* federal funds rate to determine whether the Fed is loose or tight. The real fed funds rate is the fed funds rate minus year-to-year changes in core consumer prices. At present, the real fed funds rate is about 1%. By this measure, monetary policy may appear loose, but 1% is still well above the negative real fed funds rates that prevailed following the 1990-91 recession.



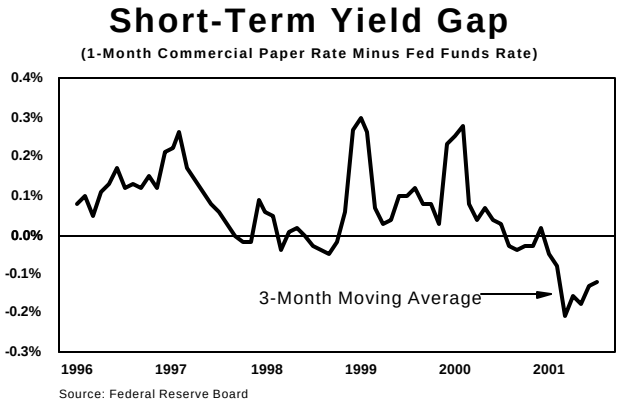


There are at least a couple of problems with using the real fed funds rate as a measure of monetary policy. First, it assumes the accuracy of government price data. This is true even if the real fed funds rate is calculated based on an expected inflation rate teased out of yields on inflation-indexed Treasury securities. If the true inflation rate is lower than government data suggest than the real fed funds rate is correspondingly higher. Second, how are we to calculate the appropriate real fed funds rate at any given time? The real rate should be lower during a slowdown (or recession) than during a strong expansion. But how much lower? Presumably, the rate should be lower during a slowdown because the demand for investment capital is lower. But if the goal is to reflect lower demand for investment capital, why not use private sector interest rates to guide monetary policy?



Long-term private sector interest rates include a real interest rate and a premium for inflation expectations. It appears as if the Fed was, to some extent, tracking yields on long-term corporate bonds from early 1995 through early 2001. Throughout the six-year period the gap between the Baa bond yield and the fed funds rate consistently hovered in a relatively narrow range between 1.5% and 3.25%. A larger gap suggests a relatively low fed funds rate and a loose monetary

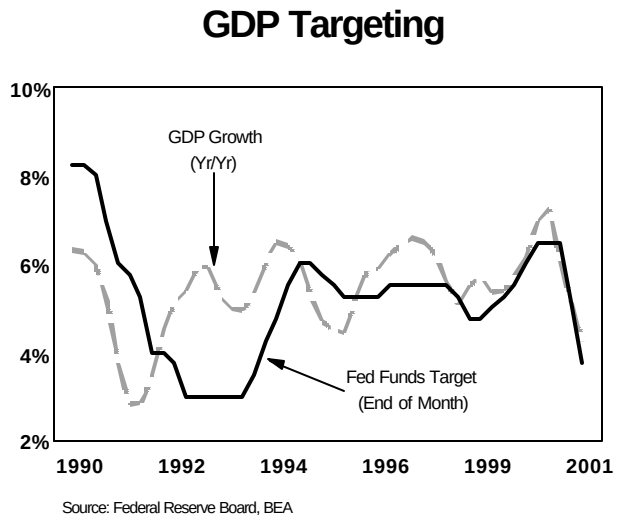
policy; a smaller gap suggests a relatively high fed funds rate and a tight monetary policy. By this measure, monetary policy now appears loose.

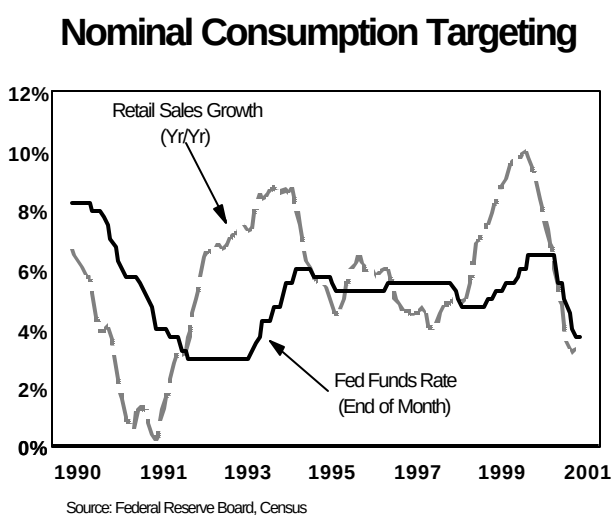


However, long-term private rates may not adequately reflect short-term investment demand and inflation expectations. If these are very low for the next few months, perhaps monetary policy *should* be easy when measured by long-term rates and then adjust when investment demand and/or inflation expectations pick up. Using, short-term commercial paper rates, the fed funds rate now appears relatively high, suggesting monetary policy is too tight. The problem with using private short-term rates is that they may already reflect expectations of further rate reductions by the Fed. Hence, using private short-term rates would make the Fed follow the expectations the Fed itself creates.

Some analysts believe the Fed is targeting (or should target) the growth rate of nominal GDP. However, there are at least a few problems with nominal GDP targeting. First, GDP is a quarterly figure, which means the Fed would have less of a chance to properly calibrate its policy. Second, increases in investment spending that increase nominal GDP lead to a tighter monetary policy, even though investment in capacity-enhancing plant and equipment should tend to put downward pressure on inflation. Third, it doesn't explain why the Fed loosened in 1991-92 when a nominal GDP rule would have advised tightening. At present, nominal GDP targeting appears to suggest the Fed is on the verge of being too loose.

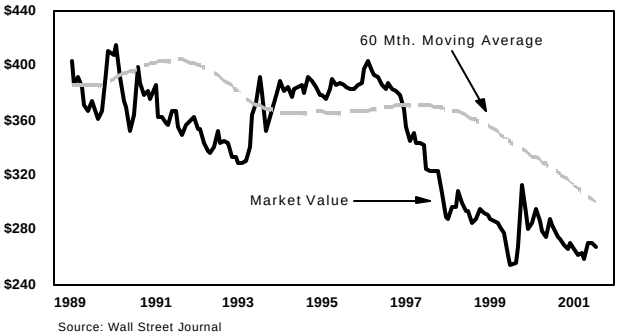
Nominal *consumption* targeting provides a better explanation of Fed policy. Since 1990, when the growth rate of retail sales has been lower than the fed funds rate the Fed has either kept rates steady or cut them. When sales growth has exceeded the fed funds rate the Fed has kept rates steady or raised them. At present, nominal consumption targeting suggests the Fed has room to cut rates down to at least 3.25%. Nominal consumption targeting has two other benefits compared to nominal GDP targeting. First, the data comes out monthly. Second, for any given level of nominal GDP growth, more investment and less consumption mean *lower* interest rates. As opposed to nominal GDP targeting, nominal consumption targeting recognizes that whether wealth is used to consume or invest has a bearing on the future price level.





Another indicator that suggests the Fed has a tight monetary policy is the price of gold. Historically, gold has been sensitive to changing expectations about the general price level. Sustained increases or decreases in gold have usually been followed by sustained increases or decreases in the general price level. For example, since 1913, the price of gold has increased at an annual rate of 3%. The consumer price index has increased at an annual rate of 3.3%. At present, gold is significantly below its 60-month moving average.

Gold



Source: Wall Street Journal

On balance, the Fed has room to reduce rates further, starting with the August 21 meeting at which it will likely cut rates another 25 basis points. Real interest rates are not as low as they were in the early 1990s, nominal consumption is growing very slowly, and the price of gold is still below its moving average. Private sector interest rates are sending conflicting signals and nominal GDP targeting is a flawed tool in that it unduly punishes investment spending.

Key Economic Indicators

Quarterly Indicators

(Q/Q, at annual rate)

	Q3-00	Q4-00	Q1-01	Q2-01
Real GDP Growth	1.3	1.9	1.3	0.7
Consumption	4.3	3.2	3.0	2.2
Business Investment	7.1	1.0	-0.2	-13.6
Trade Deficit ($ bilions)	97.3	100.3	95.0	N/A
PCE Inflation	2.4	1.9	3.2	1.7
Productivity Growth	1.4	2.3	0.1	2.5

Monthly Indicators

	May	Jun.	Jul.
Unemployment	4.4	4.5	4.5
Payroll Growth	41K	-93K	-42K
CPI Inflation (yr./yr.)	3.6	3.3	N/A
Retail Sales Growth (yr./yr.)	4.2	4.0	N/A
Corporate Rates (Baa)	8.1	8.0	8.0
Federal Funds Rate (Month End)	4.00	3.75	3.75
Dow (Month End)	10.9K	10.5K	10.5K